Development Banking

Context

- Boom in infrastructural investment and requirement for development financing, including climate finance.
- Revival of interest in development banking
- Innovative multilateral efforts: NDB and AIIB

Development banks

- Present across the world and broadly of two kinds: those that are geared to provide long term finance for development, and those mandated to provide credit to specifically targeted clients like agriculturists or SMEs, to render development more inclusive. The latter, having "an explicit legal mandate to reach socioeconomic goals in a region, sector or particular market segment", are obviously in the nature of specialized policy banks.
- It is important not to conflate the two types. From an industrial policy point of view it is the former type that is of particular interest, though SME development fits in as well.

Why development finance

- Late industrialisation requires lumpy investments, with long gestation lags to occur simultaneously in multiple industries.
- In most late industrialisers liquidity and maturity mismatches between the expectations of savers and requirements of investors results in the absence of such long –term finance
- While government can finance such investments through taxation or borrowing, the private sector often cannot because of the absence of markets for long–term finance.
- Besides, if left to markets, some sectors may not be financed because of higher costs or perceptions of risk.

The origins

- In early, late industrialising nations (Germany and Japan, for example) there were components of the financial sector that helped overcome the handicaps that such a nation suffers from.
- But here it was the mainstream banking system that was called upon to play the role, especially in the form of the Kreditbanken or universal banks in Germany and the main bank system in Japan.
- An early example was of course the Credit Mobilier in France, which however failed.

Gerschenkron's interpretation

- Gerschenkron believed they served as institutional substitutes for crucial "prerequisites" such as prior accumulation of capital or the availability of adequate entrepreneurial skills or technological expertise.
- He argued that the emergence of such "financial organisations designed to build thousands of miles of railroads, drill mines, erect factories, pierce canals, construct ports and modernise cities" was hugely transformative.
- What is left unexplained is why such institutions emerge or how they get created.

The failure

- Interestingly Piero Sraffa in his Cambridge lectures on continental banking emphasised the role of these institutions as instruments of State policy.
- He specifically addressed the problem of liquidity mismatch. Sraffa reportedly argues that while Credit Mobilier, began with a wise policy of matching maturities of assets and liabilities, it made a mistake in turning towards financing long-term investment with short-term deposits, which ultimately led to its failure.
- This he argued was because CM did not receive adequate state support. He refers to the jealousy it aroused in the Banque of France, which turned hostile, and jettisoned the CM's requests for government permission to issue long term bonds.

The issue of liquidity

- The liquidity problem arises not because banks would not be able to call in their long term credits, but that the assets they hold in the form of the securities associated with those credits may not be easily substituted with cash to meet demands to pay back depositors.
- So long-term lending is possible if an agency exists to provide lines of credit to banks engaged in such lending to industry when the former are unable to obtain liquidity from elsewhere.

The German example

- The German universal banks Sraffa argued could behave differently from British ones, because Germany built on the experience of the Credit Mobilier and got the central bank (the Reichsbank) to back them.

- De Cecco summarises Sraffa's case as follows: "German Grossbanken, which were heavily involved in maturity transformation, were likely to find themselves periodically stuck in illiquidity situations, and required reliable access to last-resort lending by the Reichsbank. In fact, the whole concept of last-resort lending, which had been developed in the English context, had to be adapted, indeed drastically transformed, to be used in the German one."

Role of the Reichsbank

- The German Reichsbank, according to Sraffa, was best thought of as the apex institution of an organically conceived centrally planned economy in which the banking system, headed by the central bank, performed the role of planning office.
- The system involved some degree of central coordination of investment allocation.
- This was possible due to the elasticity of its note issue, while the Bank of England is tied to the Bank Act's rigid note issue.

How was the moral hazard problem addressed?

- Long-term relationship and presence of nominated directors on the board gives the banks the ability to better monitor managers on behalf of itself and other stakeholders.
- Since the German universal bank closes the gap for finance AND the gap in entrepreneurship and technical capability it was often a part of the decision-making process.
- Information asymmetry problem adequately dealt with

Why special DFIs then?

- No guarantee that institutional substitutes such as these that can support late industrialisation will evolve automatically. In any case, the wait may be far too long.
- Modern commercial banks were either recent or a colonial implant and were both prone to failure and unlikely to to have the wherewithal to assess and manage risk associated with capital intensive investments.
- This might require specialized institutions to be established by the government, supported with significant resources from the budget or the central bank, and with government guarantees of borrowing.

How common are they

- By the turn of the century there were over around 520 national development banks (NDBs) in 185 countries, or an average of about 2.8 per country.
- Latin America and the Caribbean had the largest number of NDBs (152), followed by Africa (147), Asia and the Pacific (121), Europe (49) and West Asia (47).
- Survey of 90 DFIs conducted by the World Bank in 2009 (Luna-Martinez and Vicente 2012) found that 74 per cent of these institutions were entirely government owned and controlled and a further 21 per cent had less than 50 per cent of private equity ownership.

Characteristics

- Though 41 per cent of the institutions surveyed reported taking deposits, 89 per cent were borrowing from other financial institutions or issuing debt in local markets, 40 per cent had obtained budgetary transfers from the government, and 64 per cent had benefited from government guarantees of the debt they issued. 18 per cent of the institutions that received transfers declared that if transfers were withdrawn, they would not be able to operate.

- 12 per cent of them had been established before 1946, 49 per cent between 1946 (after the end of World War II) and 1989, and 39 per between 1990 and 2011, despite the change in policy orientation after 1990 in most developing countries.

Divergent policy trajectories

- In Brazil, the BNDES has emerged a giant, financing huge projects, serving as a countercyclical instrument during the recession, bankrolling Brazil's going-out strategy, and spreading its tentacles across Latin America and beyond.
- China, which did not have a development bank, established one in 1994 as part of reform.
- India and Pakistan, on the other hand, have weakened or dismantled their development banking infrastructure as part of reform.
- Surprising given the very different roles NDBs have played in Asia.

The South Korean case

- Among the factors responsible for Korea's success with its outward-oriented and mercantilist industrialisation strategy based on rapid acquisition of larger shares in segments of the world market for manufactures, was the role of the state in guiding industry to the segments of the global market that were seen as best targeted.

- For this to work, the State through its financial policies ensured an adequate flow of credit at favourable interest rates to firms investing in these sectors, so that they could not only make investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they acquire and expand market share.

The situation after World War II

- Korea had a shell of a modern financial system.
- Almost all the existing banking institutions were engaged predominantly in a regular commercial banking business consisting essentially of accepting demand deposits and of making short-term loans and advances to primary producers, to businessmen and to Government Agencies.

Korean Development Bank

- Established in 1954 with the primary objective of granting medium and long-term loans to industry.
- By the end of 1955, the KDB came to account for over 40 per cent of total bank lending.
- At one point, it accounted for 70 per cent of the equipment loans and 10 per cent of working capital loans made by all financial institutions.
- Later augmented with the KDFC and NIF.

Sources of funds

- Loans were not based on deposits.
- About a third of the loans were supported by aid counterpart funds and two thirds with financing from the Bank of Korea and the government.
- In the 1950s, 50 per cent of the funds came from the government fiscal loans programme and another 30 per cent raised by issuing bonds.

Foreign borrowing

- The KDB's charter was revised to allow it to borrow funds from abroad and guarantee foreign borrowing by Korean enterprises.
- An interesting feature of industrial finance in Korea was the guarantee system, created largely to privilege borrowing abroad over attracting foreign investment, to keep Japanese capital at bay.
- Firms wishing to borrow from abroad obtained approval from the Economic Planning Board. Once that was done the Bank of Korea (BOK) issued a guarantee to the foreign lender and the KDB issued one to the Bank of Korea.
- So, while the borrower was committed to repay the loan and carry the exchange risk, that commitment was underwritten by the KDB and BOK, which by guaranteeing against default were ensuring access to foreign borrowing.

Three phases of development finance in India

- The first began with Independence and extends to 1964 when the Industrial Development Bank of India was established, which was the phase of creation and consolidation of a large development financing infrastructure.

- The second period stretched from 1964 to the middle of the 1990s when the role of the DFIs gained in importance, with the assistance disbursed by them amounting to 10.3 per cent of Gross Capital Formation in 1990-91 and 15.2 per cent in 1993-94.

- Thirdly, after 1993-94, the importance of development banking declined with the decline being particularly sharp after 2000-01, as liberalisation resulted in the conversion of some development banking institutions into commercial banks and in a decline in the resources mobilised by other firms.

The infrastructure

- The industrial finance infrastructure consisted of the Industrial Finance Corporation of India (established in 1948), the State Financial Institutions set up under an Act that came into effect in August 1952, the Industrial Credit and Investment Corporation of India (ICICI), the first development finance institution in the private sector, established in January 1955 with a long-term foreign exchange loan from the World Bank, and the Industrial Development Bank of India (IDBI) established in 1964 as an apex development bank.

- Thus, by the end of the 1980s, the industrial development banking infrastructure in India consisted of three all-India development banks (IFCI, ICICI and IDBI), and 18 State Financial Corporations. In 1990, the government established the Small Industries Development Bank of India (SIDBI) as an all-India financial institution for the financing of micro, small and medium enterprises.

Role of the central bank

- An Industrial Finance Department (IFD) was established in 1957 within the Reserve Bank of India (RBI) and the central bank began administering a credit guarantee scheme for small-scale industries from July 1960.
- With a view to supporting various term-financing institutions, the RBI set up the National Industrial Credit (Long-Term Operations) Fund from the year 1964-65.

Outcome

- The post-1972 period witnessed a phenomenal rise in financial assistance provided by these institutions.
- Given the nature of and the role envisaged for the development finance institutions, the government and the RBI had an important role in providing them resources. In addition, public banks and the LIC and GIC also played a role
- However, India turned its back on this legacy in the mid-1990s. By 2011-12, assistance disbursed by the DFIs amounted to just 3.2 per cent of Gross Capital Formation. By 2012 there were only two all-India development banking institutions: the National Bank for Agricultural and Rural Development (established in 1982) and the SIDBI.

Conclusion

- Over a significantly long period of time, countries embarking on a process of development within the framework of a mixed, market driven economy have used the developing banking function as an important instrument of industrial policy.

- With financial liberalisation transforming financial structures, some countries are doing away with them on the grounds that equity and bond markets would do the job. DFIs are now increasingly policy banks. This is bound to have adverse implications for industrial development.